3.1 Introduction

3.2 Conceptual Development of the term Financial Integration

Hong-Giang Le (2000) has stated that, unlike trade liberalization, financial integration does not necessarily improve welfare, as the two terms ‘financial openness’ and ‘financial integration’ have been used interchangeably in the economic literature. Thus the problems relating to the mobility of capital across borders, which are actually associated with financial openness, are considered as the costs of financial integration. This study argues that financial integration always leads to welfare improvement, provided that financial integration is understood to be a distinctive concept from financial openness.

The study brings out the difference between the terms ‘openness’ and ‘integration’ using a modified Solow-Swan model for a small open economy. The study has verified the assumptions of this model using two empirical tests and data from
fifteen Asia-Pacific economies. According to the study, capital account liberalization must be implemented with greater caution, not only because financial markets and instruments are much more complicated in nature, but also because the liberalization does not always guarantee full financial integration. This is the source of the troubles confronting open economies. Thus, in attempting to liberalize capital accounts, countries should pay attention to financial openness and financial integration, the two concepts which are distinctively modeled and quantified in this study.

Pagano Marco (2002), has classified the indicators of financial integration into four broad categories: indicators of credit and bond market integration; indicators of stock market integration; indicators of integration based on economic decisions of households and firms and indicators of institutional differences that may induce financial market segmentation.

According to the study, the analysis of the asset structure is preferable to that of the liability structure because the benchmark values have more sound theoretical underpinnings. To monitor stock markets, a quantity-based indicator seems preferable to price-based ones. A promising quantity-based indicator is the share of equities managed by equity funds with an international investment strategy, which seems more reliable than simple price-based indicators such as stock market correlations. Moreover, these are much easier to compute than more sophisticated indicators based on asset price models, and can be recomputed on a regular basis. These indicators rely on existing data. New and more accurate indicators of financial market integration can be devised if new data is collected via specifically designed surveys.

Tayebi Seyed Komail, Zohre Shirani Fakhr (2009), have studied the determinants that influence the process of financial market integration in the East Asia-Pacific region. They have constructed a probit/tobit panel model, which allows them to focus on the contribution of the explanatory variables to financial integration. The probability of financial integration, using a panel probit or tobit model, has been estimated for the selected East Asia-Pacific countries over the 1990–2005 period. The study has found evidence that the size of economies proxied by GDP has a positive effect on integrating financial markets, while the results related to exchange rate and interest rate are ambiguous. The implication is that the elimination of exchange rate and interest rate risks within the East Asia-Pacific
region means the common currency, which reduces the remaining differences of investment and consumption opportunities across the member countries of the East Asia-Pacific during the implementation of financial integration.

3.3 Financial Integration and Growth

After reviewing the theoretical literature on financial development, financial integration and economic growth; Gregorio, Jose De (1996) presents new evidence on the effects of financial integration. The study suggests that the beneficial effects of financial integration on economic growth mainly come with the development of the domestic financial system. The study also highlights the benefits of foreign direct investment and its interactions with human capital. The findings and focus of this study refers to long-run growth effects of financial integration. According to the study, opening the capital account in a weakly regulated financial system may create a problem as it affects the ability of the financial system to perform its role of credit allocation adequately. Thus it is necessary to graduate and smooth out the integration of financial markets in order to preserve macroeconomic stability.

Ross Levine (2001) has discussed some conceptual issues associated with the linkages between international financial integration and economic development. The study focuses on the impact of financial integration on productivity growth and shows that by improving the functioning of domestic financial markets and banks, international financial liberalization accelerates economic growth. Liberalizing restrictions on international portfolio flows tends to enhance stock market liquidity. Enhanced stock market liquidity in turn accelerates economic growth, by accelerating productivity growth. Allowing greater foreign bank presence tends to enhance the efficiency of the domestic banking system. Better developed banking system spurs economic growth by accelerating productivity growth. Thus, international financial integration can promote economic development by encouraging improvements in the domestic financial system.

Bekaert Geert, Campbell R Harvey, Christian Lundbald (2001) show that on an average, equity market liberalizations lead to one per cent increase in annual real economic growth over a five year period. The liberalization effect is not spuriously accounted for by macroeconomic reforms and does not reflect a business cycle effect. Although financial liberalizations enhance financial
development, the measures of financial development fail to fully drive out the liberalization effect. Post liberalization, the investment/GDP ratio increases as the investment is partially financed by foreign capital. This worsens trade balances. A large secondary school enrolment, a small government sector and an Anglo-Saxon legal system tend to enhance the liberalization effect across liberalizing countries. Finally, the study has found out that once financial liberalization is accounted for, the conditional convergence effect is said to be larger.

Kose Ayhan M, Eswar S. Prasad, and Marco E. Terrones (2003) examine the impact of international financial integration on macroeconomic volatility. It is stated that, economic theory does not provide a clear guide about the effects of financial integration on volatility. The study attempts to provide a comprehensive examination of changes in macroeconomic volatility in a large group of industrial and developing economies over the period 1960–99. The study has reported two major results: firstly, while the volatility of output growth has declined in the 1990s on an average relative to the earlier three decades, the volatility of consumption growth relative to that of income growth has increased for more financially integrated developing economies in the 1990s. Secondly, increasing financial openness is associated with rising relative volatility of consumption, but only up to a certain threshold. The benefits of financial integration in terms of improved risk-sharing and consumption-smoothing possibilities appear to accrue only beyond this threshold.

Gourinchas Pierre-Olivier and Olivier Jeanne (2004) based on a calibrated neoclassical growth model, showed that conventionally measured welfare gains from financial convergence appear relatively limited for the typical emerging country. The study concludes that welfare gain from switching from financial autarky to perfect capital mobility is roughly equivalent to a one per cent permanent increase in domestic consumption for the typical emerging economy. This is negligible relative to the potential welfare gain of substantial improvement in domestic productivity observed in some of these countries. This is because less developed countries have a lower income per capita mainly because they are less productive or their economy suffers from domestic distortions, not because they are capital-scarce.

Imbs Jean (2004) has showed that, much contrary to the theory, fluctuations in GDP are more synchronized internationally than fluctuations in consumption, and
they remain so even between financially integrated economies. The results show that the correlations in GDP fluctuations rise with financial integration. Finance serves to increase international correlations in both consumption and GDP fluctuations, which explains the persistent gap between the two in the data. There is positive association between financial integration and GDP even after the effects of finance on trade and specialization are accounted for.

Schularick Moritz and Thomas M Steger (2006) have studied the financial integration–growth nexus as a comparative study between two phases of globalization (first phase-1880-1914 and second phase- 1980-2002). The study reports that international capital market integration significantly fostered economic growth in the first phase because of the combination of two key factors: there were tremendous investment opportunities in regions where financial funds were scarce and a favourable institutional setting and a comparatively stable monetary environment were secured. These two factors together gave rise to substantial net capital flows from the rich core to the poor periphery that contributed to the observed growth effect of international financial integration in the first era of global finance.

Further, the study reports that there are little indications of a robust growth effect of international financial integration in the second phase and the following reasons are identified. In the first era, global finance had (i) low differentials in property rights protection between countries; (ii) a comparatively stable monetary environment; (iii) a higher degree of capital mobility, as measured by the Feldstein-Horioka criterion and (iv) substantial net capital movements from rich to poor regions. This explains the diverse experiences in both the periods. The results emphasize that those economies which open themselves to the world economy need to abolish domestic distortions to reap the benefits of globalization. More specifically, it seems especially important to establish good property rights in all economies participating in the world economy.

Osada Mitsuhiro and Masashi Saito (2010) have studied the effects of international financial integration on economic growth using a comprehensive panel dataset that covers 83 countries for the period 1974-2007. The following issues regarding financial integration were studied –firstly, the kind of external assets or liabilities and their impact on economic growth and secondly, the countries that benefit the most from international financial integration and lastly,
whether the effects of financial integration on economic growth changed over time. It was found that FDI and equity liabilities have the largest impact on the recipient country's economic growth, while debt liabilities tend to create lower economic growth. External assets—whether they are FDI assets i.e. equity assets or debt assets—do not have a significant impact on the economic growth of the countries that hold those assets. Secondly, FDI liabilities and equity liabilities are particularly beneficial when the recipient country has good institutions or a developed financial market. In terms of geographical regions, countries in Western Europe, North America, and East Asia are more likely to benefit from financial integration due to better institutions or developed financial markets relative to countries in Africa, South America, and other regions. Thus the study concluded that the recent acceleration in the pace of financial integration has had a beneficial impact on the world economy.

3.4 Financial Integration, Growth and Poverty

Giovanni Andrea Cornia and Julius Court (2001) have showed that rising inequality threatens growth and poverty reduction targets. According to them, it will be essential to make pro-growth policies more distributionally favourable to meet the global targets for reducing poverty. A paper has pointed out following issues—inequality has increased sharply in most countries since the early-mid 1980s; there are some common factors causing the widespread surges in inequality around the world. Rather than the traditional causes of inequality, such as land concentration, urban bias and inequality in education, new causes appear to be responsible for the worsening situation. These new causes are linked to the excessively liberal economic policy regimes and the way in which these economic reform policies have been carried out. The persistence of inequality at high levels or its further rise has made it much more difficult to reduce poverty. Economic growth has less impact on reducing poverty as the level of inequality increases. High levels of inequality can depress the rate of growth as well as can have undesirable political and social impacts—on crime and political stability, etc. According to the study, countries can maintain low inequality and still grow at a fast pace like Canada and Taiwan. Rising inequality is evitable in a world dominated by technological change and globalization. Some of the main issues and different policy options to reduce inequality are also outlined in the study.
Land reforms, expanding education and active regional policy should be used to eradicate traditional causes of poverty. New causes of poverty can be eliminated by offsetting the impacts of new technologies and trade, macroeconomic stability, careful domestic and international financial liberalization and regulation, equitable labour market policies and innovative tax-and-transfer policies. At the international level, distribution issues should be included in policy advice, support policies should be designed to reduce output volatility and external budgetary support should be increased.

Santarelli Enrico and Paolo Figini (2002) reviewed the empirical evidence on the relationship between globalization and within-country poverty in the developing countries. Standard indices of trade openness, financial openness and public intervention in the economy were used to measure globalization and both indices of relative and absolute poverty averaged over five and ten years were used to measure poverty. The following conclusions are drawn: firstly, trade openness and the ‘size of the government’ seem to be associated with lower poverty levels. Conversely, financial openness, although not statistically robust, tends to be linked to more poverty. Secondly, there is a substantial difference between absolute and relative poverty analysis. Therefore, relative and absolute poverty should be considered as two separate concepts, with different meanings, measurement procedures and theoretical links with globalization. Lastly, the study suggests that globalization is a multidimensional concept and each of its dimensions have to be analyzed with care.

Agenor Pierre-Richard’s (2004) findings show the existence of an inverted U-shape relationship between globalization (i.e. Trade openness and Financial openness) and poverty. At low levels, globalization appears to hurt the poor; but beyond a certain threshold, it seems to reduce poverty possibly because it brings with it renewed impetus for reform. Thus, globalization may hurt the poor not because it went too far, but rather because it did not go far enough.

In the long term, though international financial market integration may bring significant benefits, it may entail significant short-term costs as well. Particularly in countries with imprudent sovereign debt management, improperly sequenced capital account liberalization and poorly regulated domestic financial systems, pro-cyclical nature and abrupt reversals of capital inflows have been associated with deep financial instability, economic crises and sharp increases in poverty.
rates. Financial openness can improve the opportunities for the poor to access the formal financial system by mitigating asymmetric information problems and by reducing the fixed costs associated with small-scale lending. Greater penetration of the domestic financial system by foreign banks may have mixed effects on poverty. The increased exposure to volatile shocks that is associated with financial openness may translate into higher domestic interest rates (because of the increased risk of default), lower domestic output and thus possibly higher poverty rates.

Philip Arestis, and Asena Caner (July 2004) have concluded that, in contrast to the theory, financial liberalization-led economic growth does not increase incomes and therefore does not reduce poverty. A study of three channels through which financial liberalization affects poverty—growth channel, financial crisis channel and access to credit and financial services channel is presented. The findings state that broadly, economic growth can benefit the poor directly by favouring the sectors and regions where the poor exist and the factors of production that the poor own. There are also indirect benefits that operate through redistributive policies, especially taxes, transfers and government spending.

Financial crises may not only affect the current living standards of the poor, but also their ability to grow out of poverty. The crises affect poverty and income distribution by reducing earnings of both formal and informal-sector workers, declining demand for services in the informal sector, changing relative prices, currency depreciation, contractionary fiscal policy, changes in interest rates as well as changes in asset and property prices. To alleviate poverty, poor should be equipped with consumption smoothing mechanisms, proper credit and financial services, education, safety nets and basic health services. Unless they are equipped with the proper skills to take advantage of the financial services and to manage the debt, the poor may not benefit at all from the new set of prospects. Thus, if financial liberalization were to be introduced, it must be designed with poverty reduction as its thrust in order to benefit the poor.

On analysing different measures of poverty, inequality and the concept of pro-poor growth, Nissanke Machiko and Erik Thorbecke (2005) have given an in-depth analysis of the globalization-growth-inequality and the poverty nexus. According to the study, besides growth and inequality, the changes in relative product and factor prices, differential cross-border factor mobility and associated
changes in global market and power structures, the nature of technical progress and the technological diffusion process, the impact of globalization on volatility and vulnerability, the impact of globalization on the flow of information, globalization and global disinflation and institutions in developed and developing countries that mediate the various channels and transmission mechanisms linking globalization to poverty are other important links between globalization and poverty. The threshold effects of globalization are discussed in the study with emphasis on structural transformation in general and structural transformation of agrarian economy in particular.

Heshmati Almas (2005) addresses the measurement of two indices of globalization (the Kearney Index and the Principal Component Analysis based Index) that quantify the level and development of globalization for ranking countries. The indices are composed of four main components: economic integration, personal contact, technology and political engagements. This breakdown of the index into major components offers the possibility to identify the sources of globalization and link these to economic policy measures to bring about desirable changes in national and international policies.

The relationship between inequality, poverty and globalization has been investigated. The results show that the globalization index explains only 7-11 per cent of the variations in income inequality, and 9 per cent of poverty among the countries. By decomposing the aggregate globalization index into four components, the results show that personal contacts and technology transfers reduce inequality, while economic integration increases inequality. Political engagement is found to have no significant effect on income inequality. The results provide weak evidence that globalization reduces poverty. It is reported that the regional variable plays an important role in explaining the variation in inequality and poverty, which makes the globalization coefficient insignificant. This suggests that the variations among regions are a dominant factor in how poverty and inequality are affected by the four globalization components.

Harrison Ann (2006) focuses on two aspects of globalization— the international trade in goods and international movements of capital. The study points out that the poor in countries with an abundance of unskilled labour do not always gain from trade reforms. Globalization produces both winners and losers among the poor. The financial crises are costly to the poor. The poor are more likely to share
in the gains from globalization when there are complementary policies in place. The study also shows a decline in poverty in India, with the openings for foreign investment. The study concludes on the note that the relationship between globalization and poverty is complex. The outcome depends not just on trade or financial globalization but on the interaction of globalization with the rest of the environment. The key complementary policies include investments in human capital and infrastructure, as well as policies to promote credit and technical assistance to farmers, and macroeconomic stability. Financial globalization is more likely to promote growth and poverty reduction if it is accompanied or preceded by the development of good institutions and governance, as well as macroeconomic stability.

Adam Anokye M. (2011), has reviewed the benefits of financial liberalization in Ghana through the improvements in the macroeconomic indicators. It is observed that the inflation rate dropped and the GDP growth rate increased in the period 1983-1991. In the same period, Ghana has also experienced a reduction in the poverty.

With the help of a financial liberalization index and the standard of living index, an attempt is made to investigate the relationship between financial liberalization and economic growth and the channels through which financial liberalization influence poverty reduction. The study found the existence of long run positive relationship between financial liberalization and growth as well as growth and poverty reduction. Further, credit channel was identified as a main channel through which financial liberalization influences growth and poverty reduction but needs policy intervention to realize its full potential.

3.5 Financial Integration and Developing Economies

Though financial integration has proved successful for the developed countries, it has affected developing countries differently due to different political, economic, institutional and infrastructural setup.

Prasad Eswar S, Kenneth Rogoff, Shang-Jin Wei, and M. Ayhan Kose (2003) have put focus on three issues: i) whether financial globalization promotes economic growth in developing countries; (ii) the impact of financial globalization on macroeconomic volatility in these countries and (iii) the factors that help to harness the benefits of financial globalization. Contrary to the theory, international
financial integration appears to have been accompanied by increased vulnerability to crises in some cases. There is an evidence of a threshold effect i.e. reductions in volatility are observed only after countries have attained a particular level of financial integration.

The evidence presented in this study suggests that financial integration should be approached cautiously, with good institutions and macroeconomic frameworks. According to the study, the issue whether good institutions follow capital market liberalization or whether good institutions should be in place before capital market liberalization, can be addressed only in the context of country-specific circumstances and institutional structures.

Mishkin Frederic S. (2007) has detailed out the reasons for financial repression and its implications for growth, financial globalization, financial development and its impact on economic growth especially in case of developing countries. There is a detailed discussion about the advantages and disadvantages of the financial globalization. The author has given detailed account of how and why financial globalization leads to financial crisis. Free foreign capital flows along with the mismanagement of financial globalization create the possibility of financial crisis. Severe fiscal imbalances and currency crisis add fuel to the fire and triggers a full-fledged financial crisis. Contagion plays very crucial and unavoidable role in spreading the crisis to other countries.

According to the author, financial globalization plays an important role in developing financial institutions. The development of financial institutions makes financial markets more efficient and helps to put the capital to its most productive uses. Productive use of capital is the key to promote growth and reduce poverty. Financial globalization can also have adverse impact on the economies of the countries if country cannot manage the globalized economy properly or go through financial crisis. The possibility of financial crises has failed to establish a clear and strong relationship between financial globalization and economic growth.

The author is of the opinion that though unsound economic policies are the reason for the harmful financial crises followed by financial globalization, saying no to financial globalization cannot be the solution. Furtheron, creating or improving the environment of economic growth and developing policies that promote
Successful financial development and financial globalization are required instead of rejecting financial globalization.

Aremo, Adeleke Gabriel and Aiyegbusi, Oluwole Oladipo (2011) have examined the effects of globalization on economic growth in Nigeria. The findings revealed that globalization has negative impact on economic growth in the long run, but positive in the short run. The study suggests that while Nigeria participates in the globalization exercise, caution should be exercised in opening up all its growing sectors to international competition, so as not to get affected in the long run with its accompanied negative impacts on the economy. This becomes necessary as some of the products from the technologically backward sectors of LDCS may find it difficult competing with the products from the technologically advanced sectors of the world.

According to Chapter IV 'International Financial Integration And Developing Countries' (2001), continuous reduction in impediments to capital movements and the general trends in globalization have led to the remarkable growth of cross-border capital flows. International financial market liberalization can have both favorable and adverse effects on the economies.

Financial liberalization can raise domestic investment substantially. Capital flows in general and FDI in particular, leads to technological transfer and creates spillovers from it. Financial liberalization led portfolio flows deepens domestic financial markets. The study reports that typical financial liberalization results in an increase in growth of a half of a per cent a year or more due to higher investment, greater domestic financial development and FDI spillovers. In developing countries, weak financial supervision and inconsistent macroeconomic policies may lead to excessive capital inflows, inefficient allocation of these capital flows and rapid capital outflows. This creates hindrances in realizing the growth benefits from liberalization.

Thus according to this chapter, maximizing net benefits from liberalization is the challenge for emerging market countries. These countries should create institutions that strengthen the positive aspects of financial integration. Thus, strong macroeconomic policies and sound financial systems should be developed as these enable countries to protect themselves against adverse swings in investor sentiment. Country experiences suggest that successful capital account liberalization requires careful sequencing of policies that may help reduce the
likelihood of external or financial sector instabilities. In absence of sound macroeconomic policy and financial sector reform, a slow and gradual approach to opening the capital account may be the best policy for a country following financial liberalization.

FDI flows can play an important role for the poorest developing countries. They should give top priority to making their country more attractive for domestic savings and investment and to encourage foreign capital inflows. Developing stronger financial policies and institutions can help these countries to mitigate the negative impact of liberalization on social conditions. This will reduce the poor’s exposure to macroeconomic volatility and financial crises. This will offer the opportunities to the poorer countries for higher living standards.

3.6 Financial Integration in India

India’s experience with financial integration has been widely covered in many studies. Some studies discuss financial integration and growth; some are on financial integration and financial markets in India; some have analyzed financial deepening, volatility in financial markets and some have even studied the relation between financial integration and social welfare.

According to Basudeb Guha–Khasnobisa, Saumitra N. Bhadurib (2000), capital is supposed to be invested in the sectors that are expected to have high returns and be withdrawn from sectors with poor prospects to achieve efficient capital allocation. The study shows that during the early years of financial liberalization the share of investment going to the more efficient firms did not rise, resulting in no perceptible rise in the overall efficiency of investment allocation for the economy. The analysis is indicative of a tendency noted in the Indian corporate sector towards a myopic use of funds post-1991. The surge in the availability of funds in the stock market, did not realize into any noticeable rise in gross fixed assets. Thus, the lack of an improvement in the index of efficiency of investment allocation can be partly ascribed to bad investments in the beginning. The message that emerges is that financial reforms in an inadequate regulatory framework do not necessarily have positive effects. On the positive side, the efficiency index shows improvement for sectors such as the electronics, chemicals, food and automobiles. It also shows an improvement for the mature group, when firms are classified according to age.
Ninan K.N. (2000) have showed that rural, urban and all India poverty levels have declined during the period of 20 years before the initiation of the reforms and in the post reform period this negative trend has weakened. A diversity of trends and patterns of poverty reduction have been observed across the states. Though most of the Indian states have registered and continued a negative trend in rural and urban poverty, the results were not statistically significant in most of the cases. While Gujarat and Karnataka have shown steeper decline in rural poverty, states like Punjab and Haryana have actually reported increase in the rural poverty.

Pre and Post-reform time series and cross section analyzes of all India and state-wise poverty data respectively, show that agricultural policies, improved access to subsidized food, infrastructure development programmes, measures to control inflation and reduce inequalities have proved to be most effective in reducing poverty in India. Increasing food prices have been observed to have adverse impact on the rural poverty in post-reform period in India.

Kohli Renu (2001) has made efforts to understand the nature and economic effects of capital flows as well as the appropriate policy responses to safeguard against financial instability that appears to be associated with international capital mobility. The study aims at documenting trends in the movement and composition of capital flows into India in a comparative perspective and examining the impact of these flows upon the key macroeconomic variables like exchange rate appreciation, reserve accumulation, impact upon monetary conditions and sterilization in the economy. Allowing the exchange rate to change, sterilization, the soundness and capacity of the financial system to intermediate large volumes of capital inflows as well as the relative costs of particular policies are some issues of concern discussed in the study. The study suggests that the capacity of the financial institutions to assess, price and manage risks should be created through structural changes and institutional reforms of these institutions. Excessive intermediation through the domestic banking sector has been suggested to mitigate the risk of heavy capital inflows. The monetary policy has to be separated from the exchange rate policy to be able to respond effectively to domestic objectives.

Chakrabarti Rajesh (2001) analyzes FII flows and their relationship with other economic variables, especially returns in the Indian stock market and arrives at the following major conclusions: (a) while the foreign institutional flows are highly correlated with equity returns in India, they are more likely to be the effect than
the cause of these returns. (b) The FIIs do not seem to be at an informational disadvantage in India compared to the local investors. (c) The Asian crisis marked a regime shift in the determinants of FII flows to India with the domestic equity returns becoming the sole driver of these flows since the crisis. Given the thinness of the Indian market and its susceptibility to manipulations, the FII flows can aggravate the equity market bubbles, though they do not actually initiate them.

Kohli Renu (2003) further emphasizes that the composition of flows makes a significant difference, both in terms of impact and smooth management of flows. Portfolio flows are more volatile than direct flows and are more difficult to intermediate because of their short-term, uneven nature. Thus, they have a greater impact upon stock markets and domestic money supply and can lead to consumption, stock market and real estate booms via sudden expansions in liquidity in financial markets. FDI, on the other hand, is long-term in nature. Being embedded in plant and equipment investment, it is less susceptible to sudden withdrawals and leads to productive uses of capital and economic growth. Short-term flows therefore, need to be matched by foreign capital inflows of a longer duration. It is therefore important that FDI flows are encouraged to impart stability to capital inflows. However, concerns are raised about India’s financial markets, which are still relatively thin and underdeveloped, that could pose a severe constraint on intermediating heavy volumes of volatile, short-term capital, necessitating excessive intermediation through the domestic banking sector. The study emphasizes upon structural changes and institutional reforms of the financial institutions for their capacity building and regulatory reforms to create an appropriate incentive environment in financial markets.

In India, though sterilization has been regularly used to limit the impact of capital inflows upon domestic money supply, it may serve to attract further capital inflows, which could be potentially destabilizing in some situations. Sterilization in the Indian context also has a fiscal implication. It leads to an increase in public debt, which may have negative impact on fiscal deficit and financial flows. Economic policy therefore needs to be reappraised in managing capital inflows so as to minimize the associated costs. A combination of policy responses like limited sterilization, exchange rate flexibility and short-term use of selective capital controls to specifically address the causes of capital inflow surge would be the most appropriate strategy in managing capital movements.
Lawrence Peter (2003) analyzes the various aspects of the development of India’s financial sector particularly after 1990 when financial liberalization began, focusing on the ratios of private sector credit to GDP, liquid liabilities of the financial sector to GDP, commercial bank assets to total banking sector assets and stock market capitalisation to GDP. The study found that in comparison with other developing countries in the neighbouring region and other developing countries in Asia and Latin America that have undertaken financial liberalization, India’s performance has been at a moderate level, with a better performance in the stock market indicator in the last decade. Though there is a sign of upward movement of the index of financial sector development in the 1990s, the period over which financial liberalization policies were pursued, the performance has been moderate mainly due to the weak performance in bank credit to the private sector and liquid liabilities of the financial sector. India’s performance is much below vis-a-vis the fast growing East Asian countries and the high-income countries. Thus keeping in view the current trend of Indian performance in the financial sector, this study calls for greater attention to the development of India’s banking and financial institutions.

Kletzer Kenneth M. (2004) has discussed the reforms in India at length, after discussing the theoretical advantages of financial integration and the risk-possibilities. The study points out the vulnerability of the Indian economy to financial crises with international financial integration and the policy agenda for further liberalization of capital flows. The issues such as fiscal sustainability, fiscal consequences of gradual reforms, vulnerabilities of the financial system, external vulnerabilities, etc. and the sequencing of reforms in India should be tackled successfully with the greater capital account liberalization. According to the study, the potential gains from completing capital account liberalization for India could be significant. India has much to gain from direct foreign investment and access to foreign savings for domestic investment. According to the study, the liberalization of capital inflows is not yet complete. Fiscal reforms instead of debt reduction are necessary to reduce the fiscal deficit. The institutional reforms, both fiscal and prudential, are necessary to reduce the vulnerability of the banking sector to the crisis. This will make way for the removal of the outward capital controls.
Mohan Rakesh (2004) has reviewed the era of financial repression in India and has given an in-depth account of various financial sector reforms undertaken. The paper presents the positive impact of financial sector reforms—such as improved quality of financial sector reforms and monetary management, sustained reduction in inflation, stability in the financial market, reasonably high and generally rising savings and investment rates since the 1990s, a stable real interest rate situation under the reform process and reasonably lower liquidity requirements of banks in India.

Despite the considerable progress in terms of both efficiency and stability of the financial sector under the reform process, the Indian financial system should take up certain important issues—reduction in transaction costs and improving the credit delivery mechanism, effective implementation of corporate governance practices in financial intermediaries; continuation of multiple regulators in cooperative banking; inadequate legal provisions and practice in bankruptcy of the real sector; the decline in direct bank credit towards disadvantaged but socially important sectors such as agriculture and small-scale industries.

Ultimately, this paper states that appropriate sequencing of reforms is essential for enhancing growth rate further. Reform measures should be implemented with greater force and should be speeded up for better results.

Jain Surbhi and N.R. Bhanumurthy (2005) examine the issue of short-term capital flows in the post-1991 period by using monthly data on call money rates, 91-day Treasury Bill rates, Indian Rupee/US dollar exchange rates and the London Inter-Bank Offered Rate (LIBOR). The study found that there is a strong integration of the domestic call money market with the LIBOR. Though, the study found that there is a long-term co-movement between domestic foreign exchange market and LIBOR, it is not robust. This may be due to frequent intervention by the Central Bank in the foreign exchange market. As the Government securities market in India is still in the developing stage, it was not found that the market is yet to be integrated with the international market. The study concludes that the ongoing financial reforms programme needs to be accelerated to further deepen the degree of convergence between the overseas and domestic markets. Further reforms are necessary to increase integration of the financial markets that would help reduce the arbitrage advantage in some specific segment of the financial markets.
Mohan Rakesh (2005) further discusses the financial sector reforms and changes to the monetary policy. The paper looks at various performance indicators of different segments of the Indian financial sector like progress of commercial banking, selected balance sheet indicators of commercial banks, ownership structure of public sector banks, non-performing liabilities of scheduled commercial banks, outstanding stock of central and state government securities, turnover in government securities market, trends in external value of the rupee, range of yield by maturity of primary issues, India's foreign exchange reserves, selected stock market indicators etc. In general, it is found that there has been an improvement in efficiency, competitiveness and health of all the segments of the Indian financial sector. Continued predominance of the public sector entities, India's approach towards treatment of insolvent banks, effective implementation of corporate governance practices, enforcement of creditors' rights, decline in direct bank credit towards disadvantaged but socially important sectors, appropriate sequencing and repackaging of reform process are some of the issues raised for the successful future of the financial sector.

Bhaduri Saumitra N. (2005) investigates the impact of financial liberalization on the investment patterns in a developing economy of India. The study provides mixed evidence in favour of the hypothesis that the liberalization effort has succeeded in relaxing financial constraint faced by the Indian firms. There has been a significant rise in financial constraint for the small and young firms. The study attributes this increase to the progressive reduction in government intervention in resource allocation. Although, small and young firms face more financial constraint than their large and matured counterpart even in the post-liberalized period, the result presents a convergence towards the conventional wisdom – the small and young firms are likely to face more financial constraint due to asymmetry in information in the post-reform period. The only convincing evidence in favour of the hypothesis that financial liberalization has succeeded in relaxing financial constraint can be found only in the case of the middle firms.

Ghosh Jayati (2005) in her paper considers the main elements of the financial liberalization that has become widely prevalent in developing countries. The theoretical arguments in favour of such liberalization are considered and critiqued, and the political economy of such measures is discussed. The problems for developing countries, with respect to the financial fragility and the greater
propensity to crisis as well as the negative deflationary and developmental effects, are discussed. It is concluded that there is a strong case for developing countries to ensure that their own financial systems are adequately regulated with respect to their own specific requirements.

Sen Partha (2006) has ruled out the case for immediate liberalization of the capital account for India saying that net flows to the emerging markets have trickled down to zero or even turned negative. India has not yet fulfilled the 3 prerequisites for liberalizing the capital account, namely financial sector reforms, fiscal balance and properly designed monetary and exchange rate policy. This may lead to the external crisis with the presence of capital flows. Ill functioning legal systems, thin and immature financial markets in the presence of capital account convertibility pose a challenge for Indian economy, as it may lead to the capital flight in the presence of capital account convertibility. Thus, strengthening the banking system in particular and financial system in general is the next challenge.

Capital inflows following liberalization generate an appreciation of the real exchange rate. This squeezes the domestic tradable sectors, which would put the whole liberalization process at risk. A currency hedging should also be well developed, to cope up with the greater capital flows. Fiscal and monetary policies in India have to ensure that volatility of capital flows is minimized. Low inflation, budget balance and an independent central bank are prerequisites for such a policy. Thus India should approach the issue of opening the capital account with extreme caution.

Barua Abheek (2006) has attempted to examine the issue of capital account convertibility from a practitioner’s perspective. According to him, the ultimate victims of macroeconomic shocks are micro entities like banks, corporations and individuals. Both practitioners and policymakers are equally interested in insulating them from the potential risks that the unbridled transfer of capital across borders can entail. Thus, practitioners would prefer the government to continue with its measured changes in the degree of capital mobility than going for full capital convertibility in haste. According to the author, a number of preconditions specified by Tarapore Committee I for convertibility have either been met or are close to being met. Indian companies have seen significant improvement in productivity and governance standards. This has translated into an increase in foreign investors’ interest in India. This essay argues for greater consolidation of
Indian banks in the long term and expresses concern over “weak banks” being exposed to additional risks. According to this essay, the majority of practitioners would argue for a rationalization of the existing system of controls to remove the inefficiencies within the system. The move towards capital account convertibility needs to be a steady and focused approach.

A study by Dutt Amitava (2006) has found out that empirical evidence doesn’t confirm the link between higher capital flows and higher GDP, due to the reasons like a reverse flow of capital from LDCs to rich countries, volatility in short run capital flows, pro-cyclical nature of capital flows in LDCs and financial liberalization-led banking and currency crises. In addition to this, the problems of uncertainty, asymmetric information and herd behaviour are greater in LDCs. Existence of different currencies in international market creates additional sources of instability. Because of the contagion effect, problems arising in one country can be transferred to other countries. The absence of a world central bank and the absence of monetary authorities that can regulate the amount of liquidity have greatly reduced the chances of controlling problem. Unstable capital flows can have adverse consequences on economic growth and social indicators in LDCs. The instability caused by capital flows further increases uncertainty and reduces investment. The resulting fall in output and reduced external financing leads to cuts in government expenditure especially in infrastructure and social programmes. The fall in employment and decline in government programmes increase poverty and general deterioration in social indicators unless expenditures are reallocated to the social sector.

Williamsan John (2006) states, that main pressure for liberalizing the capital flows has come from the US treasury and not from the IMF. The study has found no evidence to support the belief that a complete absence of controls brings faster growth or other economic benefits. The paper warns about the liberalization of the short term capital flows, the last step in liberalizing capital account, as it may bring costs that outweigh the benefits.

The study points out that the short term loans contribute nothing to welfare. These loans cannot safely be used to expand investment, since they may be withdrawn before the investment project matures. It is primarily the variation in the flow of short term capital like bank loans, which give rise to the pro-cyclicality of the capital account. The free capital flows create problems due to these short term
capital flows and the pro-cyclical capital flows. The author feels that, when circumstances turn difficult, the Indian economy should be in a solid position to maintain its growth. Presently full capital account liberalization promises no large benefits to India but it increases the risk of things going badly wrong.

Chandrasekhar C.P. and Parthapratim Pal (2006) showed that the Indian experience of financial liberalization indicates three important outcomes. First, increased financial fragility followed by the irrational boom in India’s stock market. Second, a deflationary macroeconomic stance adversely affects public capital formation and the objectives of promoting employment and reducing poverty. Finally, a credit squeeze for the commodity producing sectors and a decline in credit delivery to rural India and small scale industry. Financial liberalization has not realized into financial deepening, which in turn would have neutralized these ill-effects. The study also refers to the problems such as FII and stock market volatility, financial flows and fiscal contraction, implications of curbing monetized deficit, financial flows and exchange rate management, impact on real sector and development banking etc.

Mecklai Jamal and C. Chandrashekhar (2006) review the reforms in the external sector over the last few years, assess the market response and examine the possible threats that India needs to be conscious of in moving towards fuller convertibility in capital account. The study has listed the following areas of concern for Indian economy: a thin and illiquid derivatives market, over-regulation of the derivatives market, ceilings on ECBs and real estate boom. There is a need to develop a deep and liquid derivatives market, which is a necessary condition for effective risk management. There is also a need to consolidate the regulation of derivatives market, which has remained overly heavy-handed, limiting the growth in derivative volumes. India needs to be very cautious about removing the overall ceiling on external commercial borrowings.

Furtheron, real estate in India paints a worrisome picture, as real estate prices have shown an increase of 60% to 100% in the metros and some of the high-end investment could be speculative. There are also concerns with respect to global and domestic imbalances. Global imbalances are largely about high and volatile oil prices and the possibility of a sharp rise in US interest rates to support the dollar in the event of a collapse. Domestic imbalances, however, are another issue, and mainly relate to sectoral growth differences and social inequities. Thus in
conclusion, residual controls on FDI and ECBs need to be removed; tax laws and stamp duty should be simplified without scope for ambiguity and sectoral imbalances in the economy need to be addressed seriously.

Vasudevan A. (2006) has reviewed the progress of capital account liberalization in India and has reached to the conclusion that India is ready for capital account convertibility. However, the author warns that national and international financial communities recognize that financial stability is not guaranteed by either capital account convertibility or by capital controls. Vasudevan is of the opinion that the desirability of having fuller capital account convertibility should be viewed not merely from the point of view of the current or even estimated inflation rates, foreign exchange reserves, current account and fiscal deficits and Non-Performing Assets of the banking system as the precondition approach envisages, but also from the viewpoint of the institutional framework that is being continuously improved and the potential growth of the economy based on the productivity gains arising out of adoption of new technologies.

The Report on Currency and Finance, RBI (2006) has overviewed the process of financial liberalization in India as well as in the Asia region. According to the Report, wide-ranging financial sector reforms introduced since the early 1990s have largely facilitated the domestic financial market integration in India. In the process, the financial markets in India have acquired greater depth and liquidity. A key feature of global financial integration during the past three decades has reflected in the shift in the composition of capital flows to developing and emerging market economies, especially from official to private flows. Regional integration has served as a major catalyst to the global integration process during the past two decades. Apart from Asia’s growing integration with the rest of the world, increasing integration within Asia also reflects the growing intra-regional trade and financial flows. Emerging Asia has become the ‘growth center’ of the world due to the shifting of production base to the region. This is likely to stimulate greater financial integration in the region.

India’s financial integration within the region and with the international financial markets is likely to increase in future in view of its robust growth prospects. However, if benefits are to be maximized from a more integrated economy, the need is to pursue efforts towards a greater sophistication of financial markets and financial market instruments that allow risks to be shared more broadly and capital
to flow into the most productive sectors. There would also be a need to constantly review the risk management practices so that financial institutions and financial markets continue to remain resilient to adverse external developments.

Datt Gaurav and Martin Ravallion (2011) have studied the long-run trend in all three poverty measures i.e. the Headcount Index, the Poverty Gap Index and the Squared Poverty Gap Index for urban and rural India for a period of 50 years, including 15 years after economic reforms started in the early 1990s.

According to the study, both urban and rural poverty measures have shown a declining trend; rural poverty measures have historically been higher than urban measures, though the two have been converging over time. Progress against poverty has been maintained in the post reform period. Indeed, there was a higher proportionate rate of progress against poverty after 1991, although the difference in trend rates of change between the two periods is statistically significant only for the headcount index. The linear trend—the annual percentage point reduction in the poverty measures—remained about the same in the post reform period. The findings do not make a robust case for saying that the growth elasticity of poverty reduction has risen (or fallen) since the reforms began. There are also signs that the post-1991 rural growth has been less poverty reducing. The relatively weak performance of India’s agricultural sector and the widening disparities between urban and rural living standards remain important concerns, including for India’s poor.

While the rural poor have benefited more from urban economic growth in the post-reform economy, the study concludes with a warning that rural poor will be more vulnerable in the future to urban-based economic shocks.

### 3.7 Financial Integration, Growth and Employment in India

Following studies explain the empirical relationship between growth and employment in India. These studies explain the fact that growth in India has not created sufficient job opportunities.

Papola T. S. and P. P. Sahu (2012) in their research work show that in the post reform period change in growth rate of employment has been in inverse relationship with the change in GDP growth rate. The paper has also pointed out that growth rate of employment during the first decade of the 21st century, 1999-2000/2009-10, has turned out to be only 1.50, showing a long term deceleration,
with the highest GDP growth of 7.5 per cent. Employment elasticity has also sharply declined in the years following the reforms; it increased during 2000-2005 and was almost zero during 2005-10. The fastest employment growth has taken place in the secondary sector, at an annual average rate of about 3.5 per cent over the entire period 1993-94/2009-10 and agriculture sector has in fact seen a decline in employment in recent years. Services sector registered relatively high employment growth, averaging at about 3 per cent per annum over the entire post-reform period, though it was not commensurate with its GDP growth which has been over 10 per cent per annum. The paper has also noted that the deceleration in the rate of employment growth in the post-reform period can primarily be attributed to a decline in employment growth in rural areas. In urban areas, employment growth rate was higher i.e. 3.3 % p.a. in the first post-reform decade 1993-94/2004-05 but declined to 1.80 % p.a. in the period 2005-10.

Barua Abheek (2013) admits that in the post-liberalization period, employment growth in India has remained weak. He is of the opinion that lower employment growth may set in a vicious circle of lower consumption, lower demand, and lower growth; thus, growth should be made more employment intensive. According to him, in the 2004-05 to 2009-10 period, in which GDP growth hit historically its highest levels, job growth collapsed to virtually zero.

Employment growth in the organised sector seems to have been virtually zero in the post-liberalization period. There is a need to recognise the fact that without changes in the economic structure growth does not guarantee jobs.

3.8 Other studies on Financial Integration

Hoeven Rolph van der and Malte Lübker (2006) have reviewed the effects of financial liberalization on employment and income. After an initial discussion on the concepts like financial openness and financial liberalization, the study concentrates on the effects of volatility and crises on labour. External financial liberalization has led to a surge in international capital flows since the early 1990s. While the direct growth benefits of financial openness are unclear, it has led developing countries to engage in costly reserve accumulation on an unprecedented scale. This offers some protection against financial crises, but many developing countries have nonetheless experienced greater economic volatility and full-scale financial crises since the early 1990s. These crises have
had a considerable impact on GDP and long-term growth prospects, but it appears that labour has suffered disproportionately as labour market indicators typically lack economic recovery. Furthermore, the labour share in national income is typically eroded during a financial crisis.

The study draws the following conclusions: the capital account liberalization has had little direct benefits for growth for poor countries as well as for middle-income countries where the institutional gap is greatest. The opportunity cost of sterilization and large reserves is very high for developing countries; as they are mainly held in low yield treasury bonds issued by industrialized countries. Capital account liberalization has left developing countries vulnerable to crisis. The output losses associated with such crises are large; and a subsequent recovery is usually insufficient to bring a country back onto its old growth path. Open unemployment typically rises substantially during a crisis, but the impact can also be seen in a fall of real wages, rising underemployment and shifts of workers from the formal sector towards the informal economy and agriculture. Moreover, labour markets typically lag the economic recovery by several years. Thus labour pays a disproportionately higher cost. Financial crises have a permanent negative effect on the share of labour compensation in GDP. They are thus a factor behind the long-term trend decline in the labour share that can particularly be observed from the early 1990 onwards. Thus concerns for growth, labour and employment should be more explicitly taken into account in the current financial system in order for it to perform better. The study advocates development of a global financial system to provide greater liquidity, more stability for global markets and a large degree of policy autonomy for participating countries.

Gallagher Kevin P. (2011) writes that the IMF has begun to actively endorse the use of capital controls under some circumstances after more than a decade of advocating the liberalization of capital flows across national borders. The IMF has now recognised that capital inflows can be destabilising, causing currency appreciation, asset bubbles and volatility for developing countries. Whereas, capital controls on inflows can make monetary policy more independent and alter the composition of capital flows and reduce the real exchange rate pressures. There is evidence that controls on outflows are prudent as well. IMF has found that those nations that used capital controls were among the least hard hit during the worst of the crises up to 2007.
3.9 Other Relevant Studies

3.9.1 Investment and Growth

The following studies highlight the importance of investment in growth.

Anderson Dennis (1990) analyzes the old issue of determining the contribution of investment made to the growth. According to the study, growth benefits from capital accumulation in both industrial as well as developing country. Economic growth is related to three variables, the rate of investment, the social rate of return to investment and the investment-induced returns to labour.

Anwer M. S. and R. K. Sampath (1999) make an attempt to determine the long-run relationship between GDP and investment for 90 countries for the period 1960-1992. The study talks about physical capital accumulation, the investment in the infrastructure, investment in human capital and their relationship with growth. It is observed that investment in infrastructure plays very crucial role in developing countries. It makes it possible to use modern technology and stimulates productive activities.

The study found short-run causality between GDP and investment for 15 countries and long-run causality for 23 countries. Bi-directional causality has been found among 10 countries and mostly the relationship is positive. A unidirectional causality from GDP to investment has been found among 18 countries and from investment to GDP among 10 countries. There is a positive causality from GDP to investment for 11 countries and from investment to GDP for 6 countries.

3.9.2 Human capital and poverty

The following study explains the importance of human capital in poverty eradication.

G. S. Becker (1995) believed that the investments in human capital are one of the most effective ways to raise the poor to decent levels of income and health. According to the study, prior to the nineteenth century, systematic investment in human capital was not important in any country. During the nineteenth century, education, skills, and other knowledge have become crucial determinants of a person's and a nation's productivity. In the twentieth century, the primary determinant of a country's standard of living is how well it succeeds in developing and utilizing the skills, knowledge, health and habits of its population.
According to the study, it has been estimated that human capital - education, on-the-job and other training, and health - comprises about 80 per cent of the capital or wealth in the United States and other advanced countries. The importance of human capital to growth is perhaps excessively illustrated by the outstanding records of Japan, Taiwan, Hong Kong, South Korea and other fast-growing Asian economies. The study also states that more educated men and women tend to invest more in their own health and the health of their children. Indeed, education may be the most important single personal determinant of a person's health and life expectancy.

3.10 Summary
To sum up,
Discussion on the various issues related to financial integration lead us to the following conclusions:
1. As the theory suggests financial integration does not always accelerate economic growth or reduce poverty.
2. Empirical studies suggest that countries adopting financial integration can be winners or losers depending upon their domestic conditions.
3. The impact of financial integration is different for developing countries due to different economic, institutional, political set-up.
4. The relation of financial integration and poverty has been empirically studied by many researchers, but no single conclusion has been reached regarding its impact on poverty.
5. Though research studies on financial integration in India discuss various issues—financial integration and capital markets in India, financial integration and macroeconomic volatility, financial integration and growth, inequality, poverty, FII and FDI; financial integration and institutional set up, macroeconomic policy, etc., there is only one study which studied the financial integration and poverty nexus in India and tested it with econometric modelling.
3.11 Research Gaps

Following Research gaps can be identified with the help of above literature review.

1. The prominent links between financial integration and poverty in India can be further explored with the econometric modelling;

2. Non-linear relationship between financial integration and poverty can be further explored with reference to India;

3. The long-run and short-run financial integration-poverty relation in India can be tested empirically and the net impact of financial integration on poverty can be studied;

4. The financial integration-urban poverty and financial integration-rural poverty can be studied separately;

5. The complex relationship between financial integration and inequality, employment, etc. can be further explored in the economic conditions in India.